G,E-999/CI-90-1008 ORDER SETTING FILING

BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

Don Storm	Chair
Tom Burton	Commissioner
Marshall Johnson	Commissioner
Cynthia A. Kitlinski	Commissioner
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In the Matter of an Investigation into the Competitive Impact of Appliance Sales and Service Practices of Minnesota Gas and Electric Utilities

ISSUE DATE: September 28, 1994

DOCKET NO. G,E-999/CI-90-1008

ORDER SETTING FILING REQUIREMENTS

PROCEDURAL HISTORY

On September 14, 1990, the Commission issued its ORDER ESTABLISHING PROCEDURES AND DENYING PETITION TO INTERVENE in Docket No. G-009/PA-90-604, In the Matter of the Proposed Merger of Minnegasco, Inc. with and into Arkla, Inc.. In that Order the Commission addressed concerns regarding competition raised by the Minnesota Alliance for Competition (MAC), a trade organization of plumbing, electrical, and appliance associations. MAC had alleged that Minnegasco's regulated utility operations unfairly subsidize its unregulated appliance sales and service business, to the detriment of MAC's members. In the September 14 Order, the Commission found that MAC's concerns should be addressed outside of the Minnegasco/Arkla docket. The matter was later assigned to a separate complaint docket, Docket No. G-008/C-91-942.

On January 4, 1991, the Commission issued its ORDER INITIATING INVESTIGATION AND REQUIRING REPORT in the current docket. In that Order the Commission found that issues arising from the relationship of nonregulated appliance sales and service to regulated utilities merited further investigation. The Commission directed the Department of Public Service (the Department) to initiate an investigation of the appliance sales and service operations practices of all Minnesota gas and electric utilities.

On May 6, 1991, the Commission issued its ORDER REQUIRING FURTHER FILINGS IN INVESTIGATION. In that Order the Commission determined that it would further investigate appliance sales and service entities affiliated with utilities.

On August 28, 1991, the Commission issued its ORDER REQUIRING FURTHER FILINGS BY UTILITIES. In that Order the Commission found that the investigation had not proven that improper cross-subsidization of nonregulated appliance sales and service operations occurs. The Commission did find, however, that a legitimate concern still existed regarding the sufficiency of record-keeping for ratemaking purposes. The Commission therefore required the utilities to file their cost separation methodologies and actual 1990 cost separation data for Commission review. As a further safeguard against illegal discrimination, the

Commission also required gas and electric utilities which offer nonregulated sales or service to submit proposed brochures concerning the nonregulated offering.

On August 5, 1993, the Commission met to consider utilities' cost allocations and reporting methods. At that meeting, the Commission decided to delay a decision regarding cost allocations until utilities had an opportunity to comment on the following proposition: whether all utilities who are parties to the proceedings should be required to adopt fully allocated costing allocations between regulated and nonregulated activities, based on certain cost allocation principles.

In September, 1993, comments regarding utilities' cost allocations and reporting requirements for nonregulated activities were filed by Minnegasco, Otter Tail Power Company (Otter Tail), Minnesota Power, Peoples Natural Gas Company (Peoples), MAC, the Department, Northern States Power Company (NSP), and Northern Minnesota Utilities (NMU).

On November 3, 1993, the Commission again met to consider utility cost allocation and reporting requirements. At that meeting, the Commission decided to defer a decision in this matter until the Commission had an opportunity to consider issues arising from regulated and nonregulated operations in the MAC/Minnegasco complaint docket.

The Commission reached major decisions in the MAC/Minnegasco complaint docket on November 10, 1992, and March 24, 1994. In the November 10, 1992, Order the Commission required Minnegasco to adopt cost separation principles developed by the Federal Communications Commission (FCC). In the March 24, 1994, Order, following contested case proceedings, the Commission found that Minnegasco's cost allocation methods (with some modifications) were appropriate. Minnegasco's cost allocation methods were now based upon cost separation principles developed by the FCC.

On September 1, 1994, the Commission again met to consider requiring all utility parties to the proceedings to adopt fully allocated costing along specific cost allocation principles.

FINDINGS AND CONCLUSIONS

I. Introduction

The cost allocation proposal introduced by the Commission for the August 5, 1993, meeting contained three main elements: 1) the adoption of fully allocated costing to assign and allocate costs between regulated and nonregulated activities; 2) the adoption of hierarchical cost allocation principles to apportion costs between regulated and nonregulated operations; and 3) the imposition of compliance filing and annual reporting requirements.

II. Fully Allocated Costing

A. Introduction

The energy industry is currently evolving into a new, more competitive era. A federal order has required the unbundling of gas pipeline services, resulting in the creation of new competitive entities providing separate transport and sales functions. In the electric industry, the federal Energy Policy Act of 1992 has, among other things, allowed new competitive wholesale entities to sell electrical power across state lines.

One result of a more competitive energy industry is a rise in transactions between regulated utilities and their nonregulated affiliates engaged in related operations. Energy utility diversification into affiliated operations has the potential for benefiting utility ratepayers through shared costs and greater efficiencies.

Diversification into affiliated operations also holds the possibility of harm to utility ratepayers.

A monopoly utility has a natural impetus to shift costs from the nonregulated to the regulated operation, where costs are covered in rates, or to not acknowledge benefits to the nonregulated entity from joint operations. If improper cost or benefit allocations do occur, the result is subsidization of the nonregulated affiliate by the regulated utility.

The regulator's charge in the changing energy industry environment is to ensure fair, equitable sharing of burdens and benefits between regulated monopoly operations and affiliated nonregulated operations. The regulator must also ensure that energy utilities adopt systematic and comprehensive reporting methods to allow regulatory monitoring of cost and benefit allocations between regulated and nonregulated operations.

B. Fully Allocated Costing for Utilities

A fully allocated costing system divides the entire cost of a group of products among those products through direct assignment, or allocation. In utility accounting, a fully allocated costing system benefits ratepayers because efficiencies of joint regulated/nonregulated operations are shared between the regulated and nonregulated entities.

In contrast to the fully allocated approach, an incremental costing system assigns only the additional costs that result from producing one more product to that product. In utility accounting, incremental costing assigns only the additional costs of conducting the nonregulated operation to the nonregulated service, and does not share efficiency benefits with the regulated utility.

Fully allocated costing therefore provides the best opportunity for equitable sharing of burdens and benefits between utility regulated and nonregulated operations.

C. Comments of the Parties

Although they differ in their specific costing methodologies, all utilities in this proceeding agree that a fully allocated costing system is appropriate and all have adopted this approach in their accounting.

The Department recommended that all utilities in this proceeding follow the fully allocated cost approach. The Department noted, however, that flexibility must be maintained so that utilities may deviate from the fully allocated system under limited circumstances.

D. Commission Action

For the reasons previously stated, the Commission finds that fully allocated costing best serves the goals of regulatory oversight and the general public interest. The Commission will therefore require that the utilities who are parties to this proceeding adopt fully allocated costing to assign and allocate costs between regulated and nonregulated activities.

At the same time, the Commission agrees with the Department and other parties that there is a need for flexibility when adopting the fully allocated approach. As the Department noted, under certain limited circumstances, the incremental approach could be the best method of accounting for utility affiliated operations, because "recovery of something is better than nothing."

The Department and other parties also noted that some affiliated nonregulated operations are so limited in scope that applying the fully allocated system would not be cost-efficient.

The Commission will therefore qualify its adoption of fully allocated costing for parties to this proceeding. The Commission will require the parties to adopt fully allocated costing to assign and allocate costs between regulated and nonregulated activities, unless a party demonstrates that a utility's nonregulated activities are insignificant, or that the public interest is better served by another method.

With this proviso, a policy of requiring fully allocated costing should be the best means of allowing ratepayers to enjoy the benefits of diversification while limiting the risk of improper cross-subsidization. Fully allocated costing should provide the opportunity for equitable utility cost reporting and meaningful regulatory review.

III. Cost Allocation Principles

A. Introduction

In its November 10, 1992, Order in the MAC/Minnegasco docket, the Commission found that Minnegasco's cost allocation procedures required more precise identification of costs for regulated and nonregulated operations and a more unified approach to cost allocation. The Commission noted that the Federal Communications Commission (FCC) had developed a cost allocation framework which could meet Minnegasco's needs.

As the Commission noted in the November 10, 1992, Order, the FCC cost separation principles provide for direct assignment of costs between regulated and nonregulated operations whenever possible, and a theoretical framework for allocating joint and common costs. The FCC principles ensure that regulated and nonregulated operations share equitably in any cost savings realized due to joint operations. The Commission concluded that application of the FCC principles would "provide a just and reasonable cost allocation procedure for Minnegasco."

Since the November 10, 1992, Order, Minnegasco's application of the FCC principles has been found appropriate in the March 24, 1994, Order in the MAC/Minnegasco docket. The Commission has also approved NSP's application of a cost allocation system which "uses the same approach as that adopted by the FCC and meets the principles contained in the FCC regulations."[1] In each of these cases, the Commission did not require the application of FCC methodology or rules, but rather the general principles developed by the FCC.

The key element of the cost allocations principles developed by the FCC is the hierarchical approach. Extracted from the comprehensive FCC cost methodology, the basic cost allocation principles previously approved for Minnegasco and NSP by the Commission are as follows:

1. Tariffed rates shall be used to value tariffed services provided to the nonregulated activity.

2. Costs shall be directly assigned to either regulated or nonregulated activities whenever possible.

3. Costs which cannot be directly assigned are common costs which shall be grouped into homogeneous cost categories. Each cost category shall be allocated based on direct analysis of the origin of the costs whenever possible. If direct analysis is not possible, common costs shall be allocated based upon an indirect cost-causative linkage to another cost category or group of cost categories for which direct assignment or allocation is available.

4. When neither direct nor indirect measures of cost causation can be found, the cost category shall be allocated based upon a general allocator computed by using the ratio of all expenses directly assigned or attributed to regulated and nonregulated activities.

B. Comments of the Parties

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[1] In the Matter of the Application of Northern States Power Company for Authority to Increase Its Rates for Electric Service in the State of Minnesota, Docket No. E-002/GR-92-1185, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER (September 29, 1992) at p. 41.

In their written comments, Minnegasco and Otter Tail supported the concept of hierarchical cost allocation principles patterned after FCC principles. Otter Tail stated that exemptions from these principles should be possible in situations where a utility's nonregulated activities are insignificant or where the principles would not prove cost-effective.

Minnesota Power and Peoples opposed the adoption of the hierarchical cost allocation principles. Minnesota Power stated that it has been implementing fully allocated costing for ten years without a significant problem; the principles are unnecessary. Both utilities, as well as NSP, stated that requiring the adoption of the cost allocation principles would require a rulemaking.

NMU and NSP emphasized that the Commission should not require implementation of FCC methodologies.

The Department commented that the hierarchical cost allocation principles were acceptable. The Department noted that the ability to deviate from the principles would occasionally serve the public interest.

MAC supported the hierarchical cost allocation principles. MAC suggested that the general allocator calculation should be modified to exclude the cost of fuel, gas, and purchased power. MAC explained that these costs do not require the level of supervision which is required of other operation and maintenance costs. If these significant costs were not excluded from the general allocator, more common costs would be allocated to the regulated utility than is reasonable. The result would be subsidization of the nonregulated operation by the regulated utility.

MAC also recommended further annual filings by each utility and an annual Department audit of each utility's cost allocation methodology internal control system.

C. Commission Action

The Commission finds that the aforementioned hierarchical cost allocation principles are the best means of ensuring proper cost separations between regulated and nonregulated joint activities. The Commission believes that the principles will provide a clear, logical cost allocation approach which will benefit utilities, regulators, rate case intervenors, and ratepayers. For these reasons the Commission will adopt the principles as the preferred approach for parties to this proceeding to apportion costs between regulated and nonregulated operations.

Although the hierarchical cost allocation approach resembles FCC principles, the Commission does not adopt FCC methodology or rules. The Commission's policy extends only to the hierarchical cost allocation principles explained earlier in this Order.

The Commission understands that utilities differ in many essential respects, including their participation in affiliated operations. The Commission believes that the hierarchical principles offer sufficient flexibility for each utility to develop appropriate allocation methodologies based on the principles.

Should a utility wish to base its cost separations on different principles, the burden of proof would be on that utility to prove that its cost allocation principles arrive at fully allocated costs, free of any cross-subsidization. The utility would have to show that the goals of fully allocated costing, as expressed in this and other Orders, are fully realized. The utility would have the burden of demonstrating that it has considered all of its costs and that they are allocated to share burdens and benefits equitably between the regulated and nonregulated operations.

The Commission does not agree that a rulemaking proceeding would be necessary to form the Commission's policy on fully allocated costing or preferred cost allocation principles. The Commission has the option of stating policy in a contested case if all parties to the proceeding have been given notice and the opportunity to be heard. In this docket, the Commission has given ample opportunity for the parties to submit written comments and to state their positions in oral argument. No rulemaking is necessary for the Commission to adopt the policies stated in this Order.

Finally, the Commission agrees with MAC that exclusion of costs of fuel, gas, and purchased power from the calculation of the general allocator is necessary to avoid possible cross-subsidization. The Commission will add the category of "costs of goods sold" and amend the final cost allocation principle to read as follows:

4. When neither direct nor indirect measures of cost causation can be found, the cost category shall be allocated based upon a general allocator computed by using the ratio of all expenses directly assigned or attributed to regulated and nonregulated activities, excluding the cost of fuel, gas, purchased power, and the cost of goods sold.

IV. Compliance Reporting

As the Commission articulates a policy favoring certain cost allocation principles, it would be useful to determine what allocation principles and methods the parties to this proceeding are currently applying. This information could be a helpful benchmark if further investigation regarding a utility's methods should prove necessary.

The Commission will therefore require each utility in this proceeding to submit a one-time filing explaining: 1) whether its method of allocation is a fully allocated costing approach; 2) whether it complies with the recommended cost allocation principles; and 3) if it does not comply with the recommended cost allocation principles, whether its methods would accomplish similar results.

V. Requirements in Jurisdictional Annual Reporting

Under Minn. Stat. § 216B.10, subds. 2 through 4, the Commission may require utilities to maintain their books and records in the manner and form prescribed by the Commission, and to submit annual reports in the form and content prescribed by the Commission.

In order to monitor the implementation of the Commission's cost allocation policies, the Commission will require the parties to add a requirement to their jurisdictional annual reports. This additional requirement will allow the Commission to monitor utilities' cost allocations on an ongoing basis, so that any potential problems can be promptly spotted and corrected.

The Commission will require the parties to include in their jurisdictional annual reports the costs and revenues for each affiliate and nonregulated operation that results in the joint regulated and nonregulated use of resources. This requirement would not include reporting of revenues and expenses that are recorded in nonregulated FERC accounts, if revenues or expenses from the activities were never allocated. Costs or revenues would only be included in the new jurisdictional annual reporting requirement if the costs or revenues go through an allocation process to reassign some or all of the dollars.

ORDER

1. The Commission requires that all utility parties to this proceeding adopt fully allocated costing to assign and allocate costs between regulated and nonregulated activities, unless a party demonstrates that a utility's nonregulated activities are insignificant or that the public interest would be better served by another method.

2. The Commission adopts the hierarchical cost allocation principles discussed in this Order as the preferred approach for utility parties to this proceeding to apportion costs between regulated and nonregulated operations.

3. Within 60 days of the date of this Order, each utility party to this proceeding shall submit a filing explaining: 1) whether its method of allocation is a fully allocated costing approach; 2) whether it complies with the recommended cost allocation principles; and 3) if it does not comply with the recommended cost allocation principles, whether its methods would accomplish similar results.

4. Each utility party to this proceeding shall include in its jurisdictional annual report the information on cost allocations between regulated and nonregulated operations discussed in Section V of this Order. A sample filing is attached to this Order as Exhibit A.

5. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Burl W. Haar
Executive Secretary

(S E A L)